Q1 2023 EDITION

Pursant
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DEAL insider

M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

Q1 2023 Highlights:

- Middle market M&A activity returned to "normal" levels
- Valuation multiples generally held strong despite the increase in the average cost of Senior debt to over 8%
- Underwriting standards tightened for lenders; borrowers pulled back slightly

Pursant's Thoughts on the Near Future

- Macroeconomic indicators continue to point to a slowing economy, but not so much so that it will materially damper most business performance or middle market valuations
- Fed rate increases are likely to top out very soon, slowing the rising cost of capital
- 2023 calendar year is still expected to be a "good" one for M&A

First Quarter 2023 M&A Activity Reaches Pre-Pandemic Levels

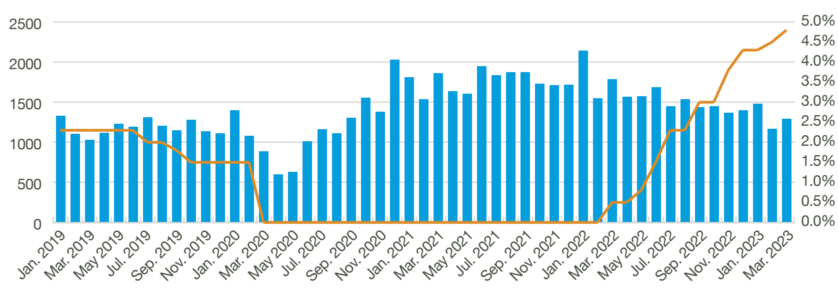
M&A activity is continuing to feel the impact of rising borrowing costs and overall concern for the slowing of the macroeconomy. Despite the fact that U.S. M&A deal activity increased in March, up 1.4% from February, the overall trend is still downward. This trend is expected to level off at some point soon, as the Fed discontinues rate hikes and eventually reverts to cutting rates once inflation nears the targeted 2% rate.

For Q1 2023, virtually all sectors experienced a decrease in M&A deal activity, relative to the same three-month period one year ago. The five sectors that witnessed the largest declines in M&A deal volume were Finance, Technology Services, Commercial Services, Health Services and Distribution Services.

As we have discussed in the past, M&A activity historically has been tied to the cost of capital, so it is normal and expected that M&A activity slows as rates rise. Chart 1 reflects this relationship between interest rates and M&A activity for the 2019 - 2023 calendar years. Once rates start to decline, M&A activity will rise.

Chart #1

2019-2023 US M&A Volume (# of deals) & Fed Funds Rate



Source: Factset®

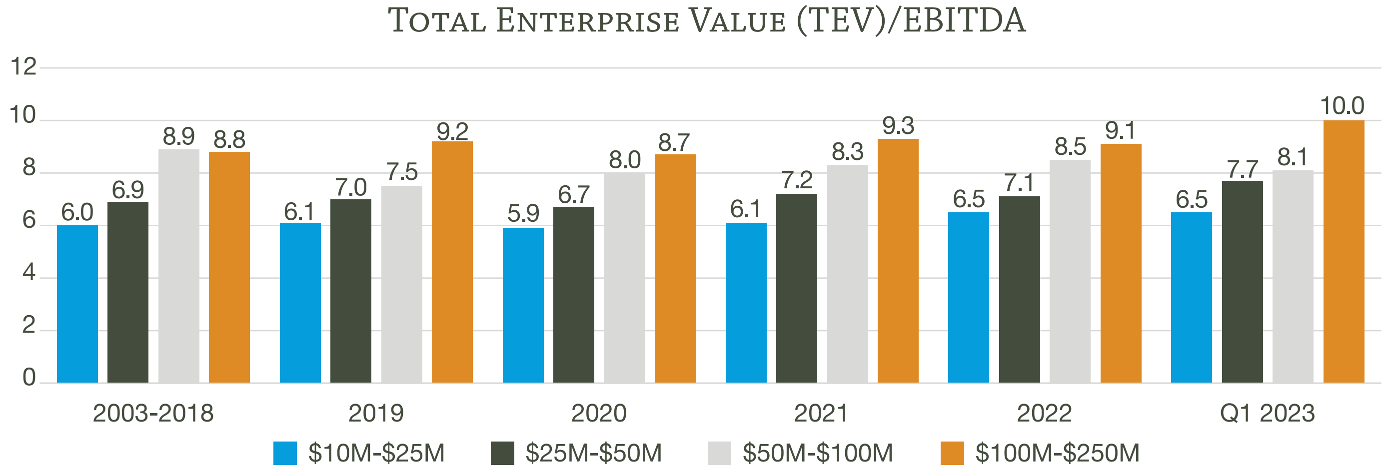
The Pursant Deal Insider is a quarterly publication offering analysis of the marketplace and climate for middle market mergers, acquisitions and strategic transactions. Our emphasis is on transactions with a total enterprise value of less than $250M. Our goal is to arm business owners and dealmakers with the insights needed to optimize transaction outcomes.

Middle market valuation multiples continue to show resilience, especially for the better performing businesses, in spite of a challenging macroeconomic environment, the increasing cost of capital and challenges in the banking sector.

Chart 2 shows that lower middle market valuation multiples for Q1 2023 averaged 8x Trailing Twelve Months (TTM) EBITDA, up from 6.8x in Q4 2022. The average purchase price of transactions valued between $100M and $250M was up nearly a full turn of EBITDA at 10.0x, compared to an average 9.1x for all of 2022. On an annualized basis, 2023 got off to an aggressive start with the 8.0x average significantly above the 7.6x average recorded for all of 2022.

Before Sellers get too emotionally anchored to these multiples, it's important to remember that they are averages of a range of valuation outcomes buried in these numbers. The range is largely affected by the "Quality Premium" —the reward in valuation for above-average financial performance. Better financial performance is defined as businesses with TTM EBITDA margin growth rates and revenue growth rates both above 10%, or one metric above 12% and the other at least 8%. ***Business that trade with a Quality Premium traded 44% higher at an average of 9.2x versus 6.4x***.

Chart #2



Source: GF Data®

EBITDA Defined *– For most middle-market businesses, valuation is typically expressed in the form of a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization)—a measurement of a company's ability to generate cash flow. EBITDA figures also serve as a barometer of the company's health and performance. Multiples of EBITDA vary greatly depending on a company's risk profile, the markets in which it operates and the likelihood of continued returns.*

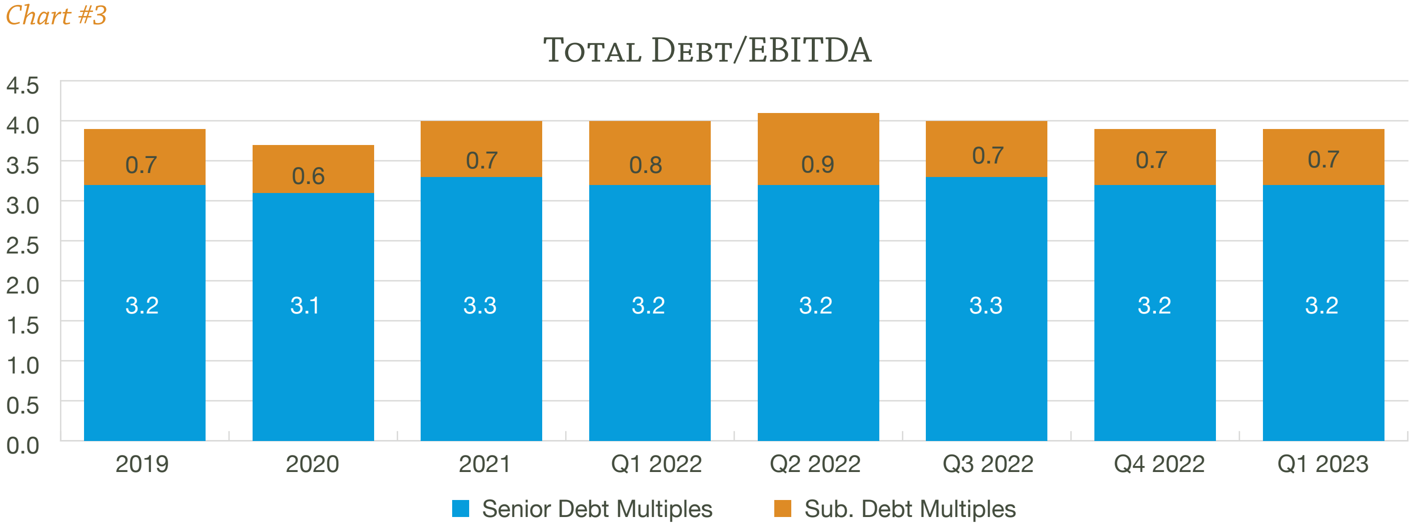
The M&A Headline These Days is the Cost of Capital—Chart 3 shows us that debt utilization has been virtually unaffected despite the Fed raising rates eight times from March of 2022 to March of 2023. Total debt for deals has averaged 3.9x EBITDA in Q1 2023, with senior debt accounting for 3.2x and subordinated debt accounting for .7x.

In Chart 4 we can see that in the first quarter of 2023, there was significant upward pressure on debt pricing, with average senior debt reaching 8.1%—nearly 1.5 percentage points higher than the average from the fourth quarter of 2022.

The average Q1 2023 sub-debt rate of 11.8% is up .5% from the same period last year. What is also notable in the Mezzanine lending environment is that warrant coverage is coming back—***there is a huge increase in reports of Mezzanine deals including warrants, confirming the idea that subordinated debt is in much higher demand now (likely due to increased underwriting standards from senior lenders)***. Mezzanine warrants are equity participation rights that are attached to a subordinated loan. The purpose of the warrants is to enhance the return to the Mezzanine lenders for making such a risky loan.

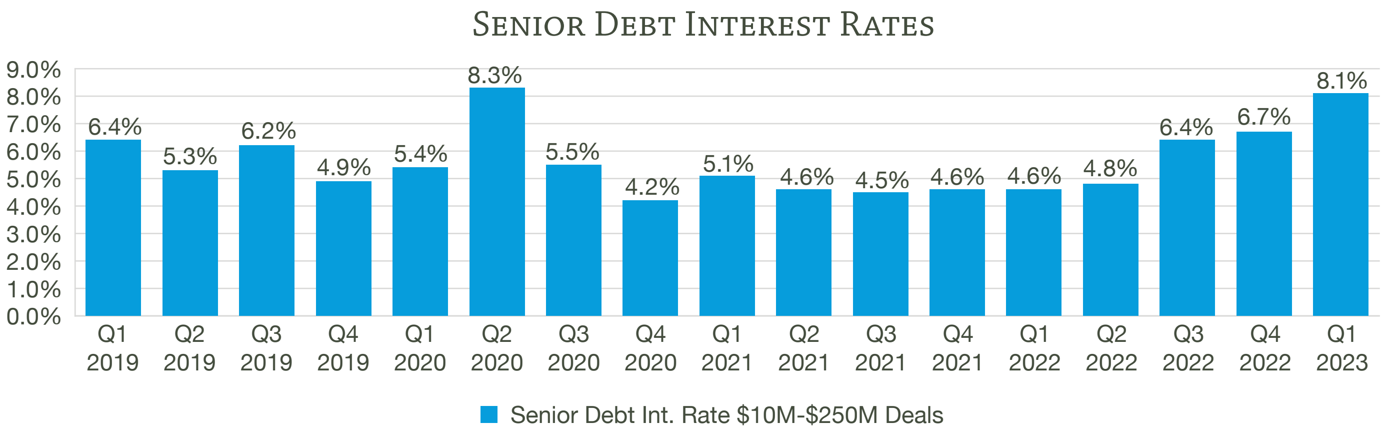
How is it that the cost of capital has increased so much, but we haven't seen across-the-board valuation multiple compression? The answer is that dealmakers need to get deals done and the number of available deals has reduced and with supply lower, multiples stay up. Some funding traditionally handled by debt, is now being filled by increasing the amount of equity being put into the deal, especially for larger platform deals. Average equity contribution increased 3.4 percentage points in the first quarter of 2023 compared to all of last year, reaching 53.6% compared to 50.2% for 2022. On larger transactions valued between $100 million and $250 million, average equity commitment reached nearly 64%, up nearly 13 percentage points compared to the average in 2022.

Chart #3



Source: GF Data®

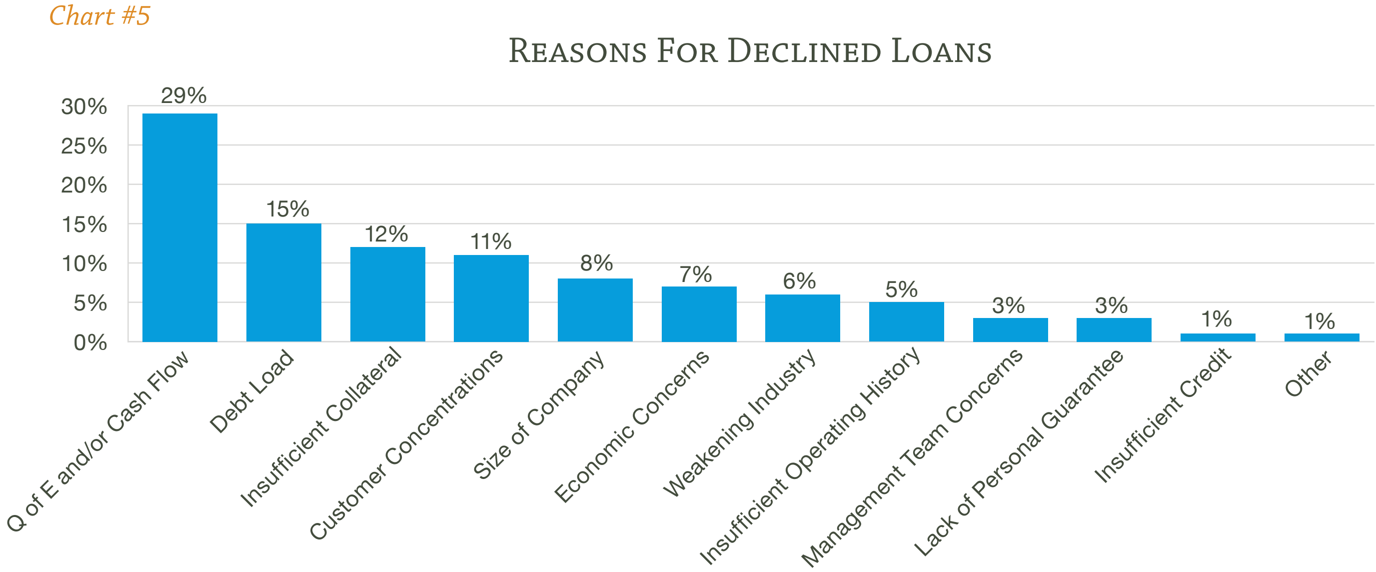
Chart #4



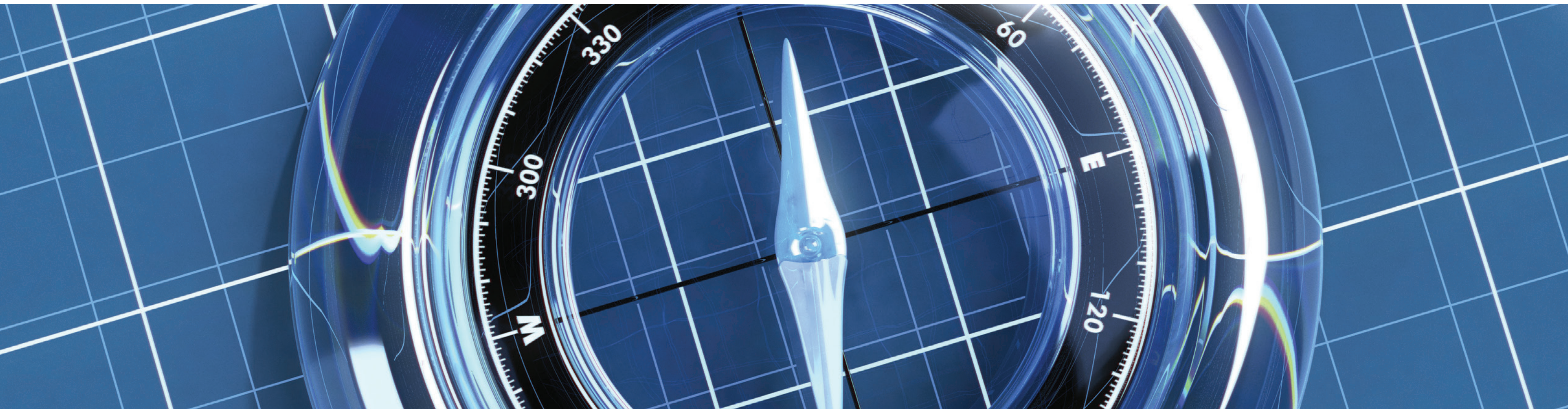
Source: GF Data®

Overall, the lending environment remains healthy, but there is no question that the standards for underwriting loans have tightened, especially for smaller loans and for businesses without recurring revenue. For example, Charts 3 and 4 are representative of deals in the $10M - $250M TEV range. For deals involving companies with less than $10M in EBITDA, Senior Debt leverage falls closer to the 1x - 2X EBITDA level and the rate of loans being declined increases. Chart 5 shows the primary reasons for loans being declined. ***Recent data shows that the likelihood of a pure cash flow loan in the lower end of the lower middle market being declined is 40%***. You can also expect to see a personal guarantee required for all loans under $25M.

Chart #5



Source: Pepperdine Private Capital Markets Report®



More on M&A Lending

In May 2023, Pepperdine Graziadio Business School published its annual *Private Capital Markets Report*. The report examines the observations and behaviors of various parties involved in deals related to the current economic environment outlook. Investor classes included in the study are lenders, private equity groups, investment bankers, venture capitalists and entrepreneurs/business owners.

Chart 6 summarizes responses across the three lender classes: Senior lenders ("banks"), Asset-Based lenders ("ABL") and Mezzanine lenders ("mezz"). Here is a brief overview of each lender class:

- *Senior Lenders*—This lender class typically consists of commercial banks that provide loans based on the assets, cash flow and earnings of businesses. For this group, loans have priority over other forms of debt, are secured by collateral of the business and carry lower interest rates relative to other capital sources.
- *Asset-based Lenders*—This group is similar to Senior lenders except that it provides loans based on the value of certain asset classes, as opposed to cash flow or earnings.
- *Mezzanine Lenders*—This lender class bridges the gap between Senior/Asset-Based lenders and Equity investors. Mezzanine loans are subordinated to other forms of debt and can have embedded equity instruments such as warrants.

Chart #6

SURVEY QUESTION	SENIOR LENDERS ("BANKS")	ASSET-BASED LENDERS ("ABL")	MEZZANINE FUNDS ("Mezz")
General sentiment	>60% of respondents believe that general business conditions will worsen over the next 12 months >60% of respondents said demand for loans will decrease	>67% of respondents believe that general business conditions will worsen over next 12 months >83% of respondents said demand for loans will increase	No statement provided
Over last 12 months seeing…	Decreased **senior** debt leverage multiples Flat **total** debt leverage multiples Big increase in general underwriting standards Flat % of loans with personal guarantee	Decreased loan advance rates Increased demand for business loans	Increased demand for Mezzanine capital Increased average investment size Decreased debt leverage multiples Worsened general business conditions Increased warrant coverage
Reasons parties are coming for capital	Expansion/acquisition Refinance existing debt/equity	Refinance existing loans or equity Expansion/acquisition	Acquisition loan Working capital fluctuations Growth capital
Key factors when making investment decision	Total debt-service coverage (or FCCR) Secondarily, leverage, net worth, current ratio	Current ratio Senior debt-to-cash flow ratio Total debt-to-cash flow ratio	Total debt-to-cash flow ratio Total debt service coverage
Good sectors	Not provided	Consumer goods/services Manufacturing Wholesale/distribution	Business services Manufacturing Health care/biotech
% of loans declined	40%	Not reported	Not reported
When Will lending return to pre-March 2020 level (% of respondents)	47% - already fully recovered 53% - 2024	33% - already fully recovered 17% - Q3 2023 33% - 2024 17% - 2025 or later	59% - already fully recovered 6% - Q3 2023 35% - 2024

The US Macroeconomic Picture for Q1 2023 and Its Impact on M&A

Q1 Shows Weak GDP Growth—The US economy grew by an annualized 1.3% on quarter in Q1 2023. Consumer spending growth accelerated more than expected, to 3.8%, despite stubbornly high inflation. On the other hand, residential fixed investment shrank at a faster pace (-5.4%). Net external demand has also contributed positively to the GDP as exports rose more than imports. Despite the upward revision, Q1 2023 GDP growth remains the weakest since Q2 2022.*

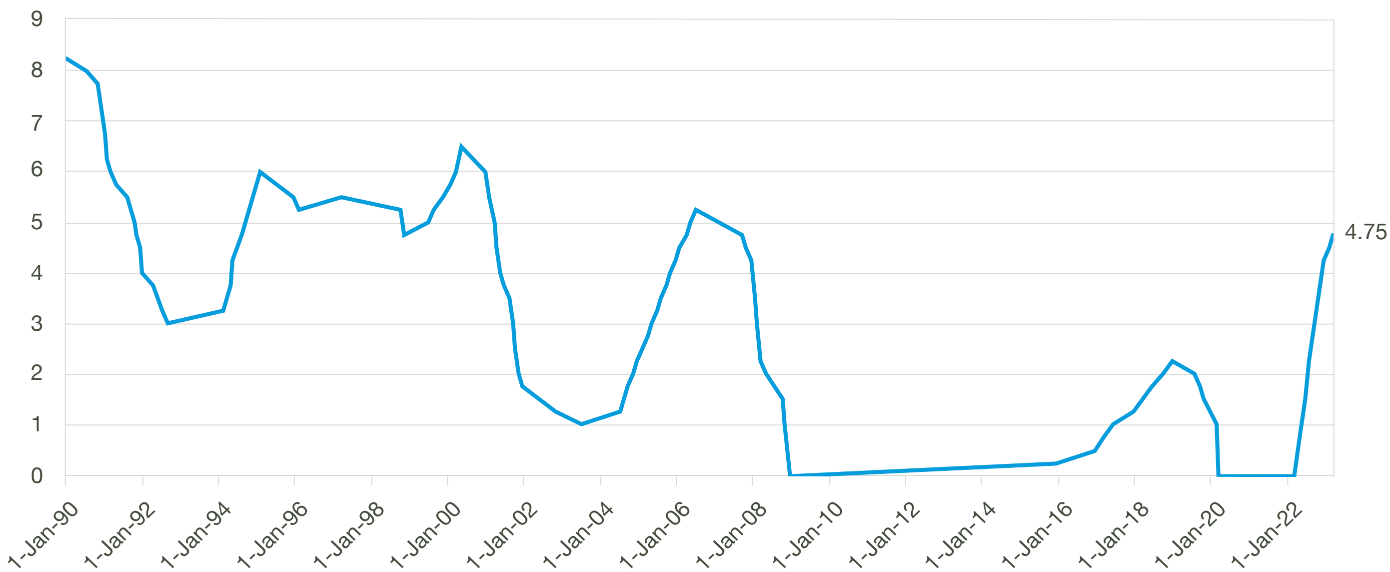
Inflation Slowed Again in Q1—The annual inflation rate in the US slowed for a ninth consecutive period, ending Q1 at 5%—the lowest since May of 2021, down from 6% in February. Food prices grew at a slower rate (8.5% vs 9.5% in February) and energy cost fell (-6.4% vs +5.2%)—namely gasoline (-17.4%) and fuel oil (-14.2%). At the same time, prices for used cars and trucks declined once again (-11.6% vs -13.6%). On the other hand, inflation for shelter, which accounts for over 30% of the total CPI basket, continued to march higher (8.2% vs 8.1%). Compared to the previous month, the CPI edged 0.1% higher. Core CPI, which excludes food and energy, increased 5.6% on the year and 0.4% on the month.*

Business Confidence Continues to Decline—The ISM Manufacturing PMI decreased to 46.3 in March 2023—the lowest since May 2020, compared to 47.7 in February —implying that rising interest rates and growing recession fears are starting to weigh on businesses. The reading pointed to a fifth straight month of contraction in factory activity, as companies continue to slow outputs to better match demand for the first half of 2023 and prepare for growth in the late summer/early fall period. A PMI reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally declining.*

Fed Lending Rate Continues to Rise—Chart 7 shows that Q1 2023 closed out with the Federal funds rate jumping to the 4.75% - 5% range. Fed Chair Jerome Powell acknowledged that inflation “has been moderating in recent months” but added that “the process of getting inflation back down to 2 percent has a long way to go and is likely to be bumpy.”

Chart #7

Fed Funds Interest Rate % (1990 - March 2023)



*Source: *Trading Economics®*

Pursant watches these macroeconomic indicators because the direction and performance of the greater economy gives us an indication of whether the Middle Market business transfer cycle is heading toward a favorable or less favorable phase.

The Importance of Market Intelligence When Considering an Acquisition

Commercial due diligence in the M&A process requires more than just a passing familiarity with financials and operations. One vital yet often overlooked aspect in the M&A process is the value of in-depth market intelligence. As companies explore potential merger or acquisition targets, it is of paramount importance to understand the target company's market position, competitive landscape, customer base and growth potential, in addition to its current and future strategies for growth.

For businesses planning to merge with or integrate the prospective target company, conducting robust market intelligence due diligence can be a real game-changer. However, not every Buyer has the resources or in-house expertise to perform this process in a detailed and nuanced manner. This underscores the need for experienced external partners who can conduct this essential analysis, providing value not only in information but also in strategy formulation. The outcome of this due diligence leads to risk identification, mitigation strategies and a well-informed transformative action plan.

Drilling Down: The Components of Market Intelligence in the Due Diligence Process

Sales and marketing due diligence revolves around a thorough assessment of a target company's market context, strategic position and growth potential. The key aspects of this multifaceted process include:

- **Market Drivers:** A Buyer can identify the target company's sustainable growth potential and adaptability by gaining a nuanced understanding what propels demand in the market. To do so involves evaluating the target company's product or service offering in the context of the trends, customer preferences and technological innovations that stimulate demand in the market.
- **Regulatory Environment:** It is also essential for a Buyer to achieve a comprehensive view of the regulatory environment impacting the target company. This includes assessing industry-specific laws, potential regulatory changes and compliance requirements, all of which could directly impact business operations, profitability and future growth prospects.
- **Key Players and Competitive Position:** By identifying the target company's main competitors and relative market standing, a Buyer can estimate its market share and growth prospects. Detailed competitor analysis helps to distinguish the key players in the market—their strengths, weaknesses and strategies. Understanding the target's competitive position—including its unique value propositions, market share and barriers to market entry—provides insights into its standing in the industry and potential future growth trajectory.
- **Customer, Distributors, and Channel Analysis:** Evaluating the target's customer base, supply chain and distribution channels can help a Buyer uncover potential vulnerabilities and opportunities. A meticulous examination of the target's customer base provides insight into customer satisfaction, loyalty and potential areas of growth or concern. A Buyer can also see potential bottlenecks or advantages in the target's supply chain by analyzing its distribution network and channels, helping to evaluate the effectiveness of its distribution strategy.
- **SWOT Analysis:** A SWOT analysis can provide a balanced view of the target company, unearthing its strengths, weaknesses, opportunities and threats. This exercise helps a Buyer learn about the target company's capabilities, potential challenges, untapped opportunities and vulnerabilities that competitors might exploit.
- **Market Potential and Growth Forecast:** A Buyer can devise a credible growth forecast by drawing on industry trends, economic indicators and market drivers, and can estimate market potential by analyzing the target's market size, potential untapped segments and growth rates.
- **Current and Future Strategy:** A rigorous appraisal of the target's strategic direction, initiatives and innovation capabilities can reveal synergies with the Buyer's own company and expose potential growth enablers. One should seek to understand the target's branding, positioning, pricing strategies and plans to adapt to market changes and customer demands.

When executed properly, detailed sales and marketing due diligence can provide valuable, actionable insights, including:

- **Key Risks:** Early action plans can be put in place by Identifying the risks associated with the potential acquisition, such as competitive threats, regulatory concerns, or possible strategic misalignments.
- **Pre-Close Items:** Any issues that need resolution prior to the transaction's conclusion can be brought to light, such as potential customer attrition or inconsistencies in strategic direction. This can make for a smooth deal closure.
- **Risk Mitigation:** Risk mitigation strategies and contingency plans can be developed by identifying potential risks and vulnerabilities.

Market intelligence is more than just a box-ticking exercise in the due diligence process. It is a strategic process that uncovers crucial market insights and helps identify potential synergies and growth opportunities. Moreover, it provides an actionable roadmap to integrate the acquisition, mitigate risk and ensure a smooth post-acquisition transition. While not all companies may have the in-house resources to conduct this comprehensive analysis, Buyers can partner with experts in the field and achieve a significant return on investment, paving the way for a successful merger or acquisition.

Pursant's Expectations for the Near Future

Despite the uncertainty in the broader economy, there has been no indication that deal volume and valuations are expected to decline significantly for the balance of this year. A number of economists are expecting a mild recession this year or next, but many companies have healthy balance sheets and are stronger than they were in previous recessionary periods. Healthier businesses should keep the M&A market active despite a slowdown in the economy.

Interest rates continue to increase and private equity firms are pulling back on how much they borrow, but they have significant undeployed capital they have raised so they are plugging the borrowing hole with equity to keep valuation multiples intact. Given the sluggish public market returns, private equity firms are also having no problem continuing to raise new money. Companies with strong financial results and recurring revenue streams will remain attractive targets and trade at healthy multiples; however, less than optimal businesses will see modest reductions in valuation multiples throughout 2023.

Public stock markets peaked at the end of 2021 and declined over the course of 2022. Then Russia's invasion of Ukraine exacerbated supply chain issues, which fueled high inflation and prompted the Fed to increase interest rates. Some form of a recession emerged and all of this brought down the value of the U.S. public equity market from $52 trillion at the end of 2021 to $40 trillion at the end of 2022. On the other hand, during the same period, valuation levels for private middle market companies have held relatively flat. This middle market resilience will continue to be attractive to Buyers seeking acquisitive growth and Sellers seeking some form of a liquidity event in 2023.

Pursant is an investment banking, financial and management consulting firm that supports and executes middle market M&A related initiatives and helps business owners grow enterprise value.

Our Investment Banking practice helps business owners make a profitable exit from the company they have built or launch and manage acquisition initiatives that will take their business to the next level.

Our Financial Consulting practice delivers the strategy, skills and brainpower needed, in the form of advisory or interim financial professionals, to support and augment finance teams with needs often related to strategic transactions.

Our Management Consulting practice provides customized solutions designed to re-shape conventional thinking about growing enterprise value.

We use a deep immersion process, our expansive networks and experience as owner/operators, dealmakers and sector experts to effectively deliver on these critical initiatives for which most companies do not have the time, manpower or expertise.

To learn more about how Pursant can help you, email info@pursant.com or visit www.Pursant.com.

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